

UNITED STATES DISTRICT COURT  
CENTRAL DISTRICT OF CALIFORNIA

ROBERT G. PERRIN and DIANE L.)  
PERRIN, Individually and on Behalf of  
All Others Similarly Situated,

Plaintiffs,

vs.

SOUTHWEST WATER COMPANY,  
ANTON C. GARNIER, MARK A.  
SWATEK, CHERYL L. CLARY,  
PETER J. MOERBEEK and KPMG  
LLP,

Defendants.

2:08-cv-7844-JHN-AGR<sub>x</sub>

**OMNIBUS ORDER GRANTING  
MOTIONS TO DISMISS AND  
DENYING MOTION FOR  
PARTIAL SUMMARY JUDGMENT**

This matter is before the Court on Defendants SouthWest Water Company's ("SWWC" or "the Company"), Anton C. Garnier's, Mark A. Swatek's, Cheryl L. Clary's, Peter J. Moerbeek's ("the individual defendants") (collectively "Southwest Defendants") and KPMG's (Collectively "Defendants") Motions to Dismiss the Consolidated Amended Class Action Securities Complaint ("CAC") (docket nos. 38 & 43), and defendant SWWC's Motion for Partial Summary Judgment (docket no. 34). The Court has considered the moving, opposition, and reply documents submitted in connection with these

1 Motions and deems this matter appropriate for decision without oral argument.  
 2 *See* Fed. R. Civ. P. 78(b); Local Rule 7-15. Accordingly, the hearing set for June  
 3 21, 2010 was taken off calendar. For the reasons set forth below, the Motion for  
 4 Partial Summary Judgment is DENIED, the Motion to Dismiss Claim II is  
 5 GRANTED, and the Motion to Dismiss the Amended Complaint is GRANTED.  
 6 The Court also hereby GRANTS KPMG's unopposed Motion for Joinder in  
 7 SWWC's Motions. (Docket no. 45.)

## 8 9 **I. EVIDENTIARY RULINGS**

10 Defendants request that the Court take judicial notice of, *inter alia*, a  
 11 variety of SEC filings, publicly filed documents from other federal court  
 12 proceedings, accounting rules, analyst reports, and select Sarbanes-Oxley  
 13 certifications ("SOX Certifications"). These items are either (a) publicly filed  
 14 records, (b) information, the accuracy of which cannot be reasonably questioned,  
 15 or (c) documents on which the allegations in Plaintiff's CAC necessarily rely.  
 16 Accordingly, the Court GRANTS Defendants' requests for judicial notice (docket  
 17 nos. 42, 64). Further evidentiary objections either relate to evidence not  
 18 necessary for purposes of addressing these motions, or shall be addressed in the  
 19 discussion below.

## 20 21 **II. FACTS AND LEGAL PROCEEDINGS**

22 The following undisputed facts are gleaned from Plaintiffs' CAC, which  
 23 was filed after a consolidation of several related matters pending before the Court.  
 24 This is a putative class action on behalf of all persons or entities who purchased  
 25 or otherwise acquired the common stock of SWWC between May 10, 2005 and  
 26 November 10, 2008, inclusive (the "Class Period"). (CAC ¶ 1.) Distilled to its  
 27 essence, the CAC alleges that SWWC's July 9, 2009 restatement ("the  
 28 Restatement") of its prior years' financial statements rendered those prior

1 financial statements “false and misleading” when issued, and by extension, that  
2 SWWC’s auditor, KPMG, issued audit opinions and reports on SWC’s internal  
3 controls that were “false and misleading” when issued. The Lead Plaintiffs in this  
4 action are Richard J. Hemmer, Paul M. Zatulove, Gus Karozos, and Lionel  
5 Patenaude (“the Hemmer Group”). These individuals “suffered damages as a  
6 result of their purchases or other acquisitions of the common stock of SouthWest  
7 as detailed in their Certificates of Named Plaintiffs previously filed with the  
8 Court.” (CAC ¶ 25.) Plaintiffs Nelson W. Bush, Joseph Yeatte and Thomas  
9 Moshier (the “Securities Act Plaintiffs”) purchased stock pursuant to the  
10 Company’s Dividend Reinvestment and Stock Purchase (“DRIP”) Plan, as  
11 amended (the “Plan”). (CAC ¶ 26.) Finally, Plaintiff Howard Fosman “suffered  
12 damages as a result of his purchases or other acquisitions of the common stock of  
13 SouthWest[.]” This Order shall hereinafter refer to “Plaintiffs” collectively.

14 SWWC is a company that provides water, wastewater treatment, and public  
15 works in nine states. SWWC and its subsidiaries provide a range of services  
16 including water production, treatment and distribution, wastewater collection and  
17 treatment, utility billing and collection, utility infrastructure construction  
18 management, and public works services. (CAC ¶ 28.) KPMG was SWWC’s  
19 auditor from approximately 1993 until it was replaced after the December 31,  
20 2007 audit. (CAC ¶ 35.) Defendant Anton Garnier was the CEO and Chairman  
21 of SWWC’s Board of Directors until his resignation on May 15, 2006. (CAC ¶  
22 29.) Defendant Mark Swatek became the CEO when Garnier resigned in 2006  
23 and remains in that position today. (CAC ¶ 30.) Defendant Cheryl Clary, a  
24 certified public accountant, joined SWWC in October 2004 as Chief Financial  
25 Officer, a position she held until May 2009, when she became Senior Vice  
26 President of Finance. (CAC ¶ 31.) Defendant Moerbeek, also a certified public  
27 accountant, was SWWC’s President and Chief Operating Officer until he resigned  
28 in June 2006. (CAC ¶ 32.)

1 On November 10, 2008, SWWC announced that its financial statements for  
2 2005, 2006, 2007, and the first two quarters of 2008 would be reaudited by  
3 PricewaterhouseCoopers LLP (“PwC”) and restated. (CAC ¶¶ 4, 5, 405–06.)  
4 The Company acknowledged that it had committed widespread accounting errors  
5 and made “inappropriate accounting decisions” over the previous years, which  
6 had inflated the Company’s financial health. (CAC ¶¶ 3, 171, 406.) The CAC  
7 alleges that Defendants 1) capitalized costs that should have been expensed; 2)  
8 failed to eliminate intercompany profits; 3) under-appreciated assets; 4)  
9 recognized revenue on the cash basis instead of the accrual basis; 5) failed to  
10 account for existing liabilities; and 6) improperly accounted for acquisitions,  
11 among other violations of GAAP. (CAC ¶¶ 2, 127-61, 239.) The Company also  
12 revealed that its financial internal controls system had suffered from fifteen  
13 material weaknesses during the Class Period including its failure to “maintain an  
14 environment that consistently emphasized strict adherence to generally accepted  
15 accounting principles.” (CAC ¶¶ 3, 171.6.) The fifteen material weaknesses are  
16 summarized as follows:

17 1. Did not maintain an effective control environment because of the  
18 following material weaknesses:

- 19 • Did not maintain an environment that consistently emphasized  
20 strict adherence to GAAP;
- 21 • Did not maintain sufficient complement of resources with an  
22 appropriate level of accounting knowledge;
- 23 • Did not maintain complete and accurate business  
24 documentation;

25 2. Did not maintain effective monitoring of controls over areas  
26 including period end financial reporting process, acquisition  
27 accounting, goodwill, regulatory accounting, stock-based  
28 compensation, property, plant and equipment, estimates and  
accruals;

3. Did not maintain effective controls over risk assessments;

4. Did not maintain and communicate sufficient and consistent  
accounting policies with respect to generally accepted accounting  
principles;

1 5. Did not maintain effective controls over the recording of journal  
2 entries both recurring and non-recurring;

3 6. Did not maintain effective controls over the completeness and  
4 accuracy of key spreadsheets and system-generated reports;

5 7. Did not maintain effective controls over the application of GAAP  
6 commensurate with financial reporting requirements;

7 8. Did not maintain effective controls over the completeness and  
8 accuracy of our accounting for acquisitions;

9 9. Did not maintain effective controls over the completeness,  
10 accuracy and valuation of our accounting estimates related to our  
11 claims process associated with medical, automobile and workers'  
12 compensation self-insurance;

13 10. Did not maintain effective controls over the completeness and  
14 accuracy of our accounting for the impairment of goodwill.

15 11. Did not maintain effective controls over the completeness and  
16 accuracy of our accounting for regulated entities;

17 12. Did not maintain effective controls over the accuracy and  
18 valuation of stock-based compensation;

19 13. Did not maintain effective controls over the completeness and  
20 accuracy of property, plant and equipment and related depreciation  
21 expense;

22 14. Did not maintain effective controls over the completeness and  
23 accuracy of unbilled utilities revenue;

24 15. Did not maintain effective controls to ensure the completeness of  
25 the recording of accounts payable and accrued liabilities, operating  
26 expenses and property, plant and equipment additions on a timely  
27 basis.

28 (CAC ¶ 171.)

As a result of the restatement, revenue was adjusted downward for the  
years 2004, 2005, 2006, and 2007. (CAC ¶ 55.) Operating income, net income,  
and income from continuing operations were also cut for the years 2004, 2005,  
and 2006. (*Id.*) Retained earnings for 2005, 2006, and 2007 were each cut: from  
\$22.2 million to \$5 million for 2005, from \$27 million to \$6.3 million for 2006,  
and from \$13.3 million to \$2.2 million for 2007. (CAC ¶¶ 62–64.) Net cash for  
2006 and 2007 were reduced to 21% and 26% of their previously reported levels,  
respectively. (CAC ¶¶ 65–66.)

*Allegations*

On October 15, 2009, after several cases against Defendants were consolidated, Plaintiffs filed the CAC. The CAC pleads Claims for Relief against: 1) The Southwest Defendants for violation of Section 11 of the Securities Act of 1933 (“the Securities Act”), 15 U.S.C. § 77k; 2) KPMG for violations of Section 11(a)(4) of the Securities Act 15 U.S.C. § 77k(a)(4); 3) The individual defendants for violations of Section 15 of the Securities Act, 15 U.S.C. §77o. The CAC also alleges that 1) the Southwest Defendants violated Section 10(b) and Rule 10b-5 of the Securities Exchange Act of 1934, 15 U.S.C. § 78 *et seq.* (“the Exchange Act”); 2) the Individual Defendants violated Section 20(a) of the Exchange Act; 3) Violations of Section 20A of the Exchange Act on Behalf of Plaintiff Fosman Against Defendants Garnier and Moerbeek.

*Current Motions Pending Before the Court*

On January 12, 2010, the Southwest Defendants filed a Motion for Partial Summary Judgment as to Claims I and III of the CAC (docket no. 34) and a Motion to Dismiss the CAC in its entirety (docket no. 43). KPMG filed a Motion to Dismiss Claim II (docket no. 38). On January 22, 2010, KPMG filed an unopposed Motion for Joinder in the Southwest Defendants’ Motion to Dismiss. (Docket no. 45.) Opposition and reply papers have since been filed.

### III. SECTION 11 CLAIMS

Section 11 of the 1933 Securities Act creates a private remedy for “any person acquiring” a security for which “any part of the registration statement, when such part became effective, contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading.” 15 U.S.C. § 77k(a). “To prevail in such an action, a plaintiff must prove (1) that the registration statement contained an omission or misrepresentation, and (2) that the omission or misrepresentation

1 was material, that is, it would have misled a reasonable investor about the nature  
 2 of his or her investment.” *Rubke v. Capitol Bancorp Ltd*, 551 F.3d 1156, 1161  
 3 (9th Cir. 2009) (citation and internal quotation marks omitted).

#### 4 *The Registration Statements*

5 Here, Plaintiffs’ Section 11 allegations stem from “the Company’s false  
 6 and misleading registration statements or prospectuses filed on Form S-3/A  
 7 [Amended Registration Statement] and S-3 [Registration Statement] on April 5,  
 8 2005 and April 19, 2006, respectively (and effective and/or amended for purposes  
 9 of this action on March 16, 2006, April 19, 2006, March 16, 2007, and March 31,  
 10 2008), and issued in connection with the Company’s [DRIP Plan.]” (CAC ¶ 1.)  
 11 The DRIP permits SWWC shareholders to elect to use a dividend declared by  
 12 SWWC to purchase SWWC common stock, sometimes at a discounted price,  
 13 rather than receiving the dividend in cash. On April 5, 2005, the Company filed  
 14 on Form S-3/A “an amended registration statement (Registration No.  
 15 333-121426, dated April 4, 2005) for the issuance of 500,000 shares of the  
 16 common stock[.]” (CAC ¶ 71.) On April 19, 2006, “the Company filed on Form  
 17 S-3 a registration statement for 1,462,514 shares, priced at \$15.63 per share, to be  
 18 issued pursuant to the DRIP (Registration No. 333-133399)[.]” (CAC ¶ 81.)

19 The only allegations leveled against KPMG are for violations of Section 11  
 20 based upon KPMG’s audit opinions and related reports on internal controls that  
 21 were included by SWWC in its SEC Form 10-K filings for 2005, 2006, and 2007,  
 22 and incorporated by reference into SWWC’s registration statements (as  
 23 amended). KPMG challenges the CAC on the following grounds: 1) the claim  
 24 against KPMG violates the three-year statute of repose applicable to claims  
 25 brought under Section 11; 2) the CAC does not allege with the necessary  
 26 specificity, among other elements, that KPMG made materially false statements  
 27 in registration statements of SWC; 3) the individual plaintiffs have failed to allege  
 28 sufficient facts to establish standing. The SouthWest defendants challenge the



1 Section 11 cause of action in a Motion for Partial Summary Judgment and in a  
2 Motion to Dismiss.

### 3 **A. Statute of Repose**

4 Section 13 of the Securities Act establishes a statute of repose for Section  
5 11 claims. 15 U.S.C. § 77m. The statute provides: “[i]n no event shall any such  
6 action be brought to enforce a liability created under section [11] . . . more than  
7 three years after the security was bona fide offered to the public[.]” *Id.* KPMG  
8 argues that the Section 11 cause of action was not asserted against them until the  
9 CAC was filed on October 15, 2009. Thus, the statute of repose began to run on  
10 the effective dates of the two registration statements at issue—April 5, 2005 and  
11 April 19, 2006—causing the clock to run out on or before April 5, 2008 and April  
12 19, 2009, respectively. Plaintiffs counter that the Section 11 claim is timely  
13 because: (1) Plaintiffs bring their claim pursuant to the registration statements’  
14 post-effective amendments; and (2) Plaintiffs’ Complaint relates back under Rule  
15 15(c)(1)(B) to the two initially filed class action complaints that named KPMG.  
16

#### 17 *I. Whether Registration Statements Issued During the Class Period* 18 *are “New” Offerings*

19 Plaintiffs argue that the DRIPs are shelf registration statements. A court  
20 recently described the significance of shelf registration as follows:

21 [I]n a shelf registration, the issuer files a registration with the SEC and  
22 then either (1) keeps this registration “on the shelf” by waiting until a  
23 later date to go effective; or (2) completes one offering of less than the  
24 authorized securities on the effective date and puts the registration  
statement on the shelf for further issuances at later dates. The delayed,  
continuous, or serial offerings may continue until they reach the total  
issuance authorized by the shelf registration.

25 *In re Countrywide Financial Corp. Securities Litigation*, 588 F. Supp. 2d 1132,  
26 1164 (C.D. Cal. 2008). “[W]hen the registration is a ‘shelf registration’ under  
27 SEC Rule 415, the filing of a ‘post-effective amendment shall be deemed to be a  
28 new registration statement relating to the securities offered therein[.]’” *In re*



1 *Metropolitan Securities Litigation*, 532 F. Supp. 2d 1260, 1284 (E.D. Wash.  
2 2007) (quoting 17 C.F.R. § 229.512(a)(2)(1990)). “Without § 229.512(a)(2), this  
3 ongoing reporting requirement would be meaningless, since purchasers who  
4 acquired securities in a shelf offering more than three years after the initial  
5 registration would find their § 11 claims barred by the time limits of § 13, even if  
6 they bought the securities in reliance on a fraudulent, post-effective amendment to  
7 the registration.” *Finkel v. Stratton Corp.*, 962 F.2d 169, 174 (2d Cir. 1992).

8 Plaintiffs have submitted a declaration stating that the Securities Act  
9 Plaintiffs purchased some of their securities in 2007, after the 2006 10-K  
10 amendment, thereby acquiring their securities pursuant to those registration  
11 statements and bringing their 2009 cause of action within a three year repose  
12 period that would end in 2010. KPMG challenges this declaration on the ground  
13 it is a hearsay summary signed by Plaintiffs’ attorney rather than a sworn  
14 declaration pursuant to the Securities Acts’ requirement that “[e]ach plaintiff  
15 seeking to serve as a representative party” file a “sworn certification, which shall  
16 be personally signed by such plaintiff” with the complaint that “sets forth all of  
17 the transactions of the plaintiff in the security that is the subject of the complaint.”  
18 15 U.S.C. § 77z-1(a)(2)(A).

19 This argument is a non-starter. The CAC alleges that the Securities Act  
20 Plaintiffs represent “all members of the Class who purchased or otherwise  
21 acquired SouthWest common stock issued pursuant to, or traceable to, the S-3/A  
22 and S-3 registration statements, and post-effective amendments thereto, including,  
23 but not limited to, the 2005, 2006, and 2007 10-Ks[.]” (CAC ¶ 196.) Each of the  
24 Securities Plaintiffs signed a sworn certification, attached to the CAC, that lists  
25 securities purchased after the 2006 10-k. Indeed, KPMG in its reply appears to  
26 shift gears and merely asserts that “*a vast majority* of their purchases are  
27 untimely[.]” and that the Securities Plaintiffs “are predicating their § 11 claim *in*  
28

1 *large part* on purchases made pursuant to registration statements that became  
 2 effective outside the statute of repose.” (Reply 1, 5, emphasis added.)

3 So, while Securities Plaintiffs are not time-barred by the limitations of the  
 4 Securities Act, they are only permitted to go forward in this litigation pursuant to  
 5 shares purchased within the repose period prior to the action filed against KPMG  
 6 on October 15, 2009.<sup>1</sup>

### 7 **B. Standing**

8 KPMG and the Southwest defendants advance similar arguments in an  
 9 attempt to dispose of the Section 11 cause of action on standing grounds. KPMG  
 10 argues that Lead Plaintiffs have failed to allege explicitly that they purchased a  
 11 security issued pursuant to, or traceable to, the specific registration statement  
 12 containing an alleged material false statement or omission, thereby arguing that  
 13 the Complaint should be dismissed for failure to state a claim. The SouthWest  
 14 defendants present a more reticulated argument, based on a similar assertion, in  
 15 their Motion for Partial Summary Judgment: “while on April 5, 2005 and April  
 16 19, 2006, SWWC filed registration statements for certain shares associated with  
 17 the DRIP Plan . . . , such shares were placed in the general reserve pool (together  
 18 with shares registered pursuant to other registration statements) and the actual  
 19 shares purchased by Plaintiffs pursuant to the DRIP Plan are not necessarily those  
 20 shares that were registered pursuant to the DRIP Registration Statements.” (Mot.  
 21 2.) SouthWest Defendants conclude that “[s]ince Plaintiffs cannot trace their  
 22

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23 <sup>1</sup>The Court rejects Plaintiffs’ “relation back” argument as the only related actions filed  
 24 against KPMG prior to October of 2009 were filed by different plaintiffs who were 1) not parties  
 25 in the CAC; and 2) sought to assert different claims that did not reference the registration statements  
 26 upon which the current Section 11 claim is predicated. *See, e.g., David Harroch v. Southwest Water*  
 27 *Company et al.*, 2:08-cv-08088-FMC-AGR; *In re Syntex Corp. Securities Litigation*, 95 F.3d 922,  
 28 935 (9th Cir. 1996) (“An amendment adding a party plaintiff relates back to the date of the original  
 pleading only when: 1) the original complaint gave the defendant adequate notice of the claims of  
 the newly proposed plaintiff; 2) the relation back does not unfairly prejudice the defendant; and 3)  
 there is an identity of interests between the original and newly proposed plaintiff.”)

SWWC stock to the DRIP Registration Statements, they do not have standing to assert Section 11 claims.” (*Id.*)

### **1. Southwest Defendants’s Motion for Summary Judgment**

#### *a. Legal Standard*

Summary judgment is appropriate if there is no genuine issue of material fact and the moving party is entitled to judgment as a matter of law. Fed. R. Civ. P. 56(c). The moving party bears the initial responsibility of informing the court of the basis of its motion and identifying those portions of “‘pleadings, depositions, answers to interrogatories, and admissions on file, together with the affidavits, if any,’ which it believes demonstrate the absence of a genuine issue of material fact.” *Celotex Corp. v. Catrett*, 477 U.S. 317, 323, 106 S. Ct. 2548, 91 L. Ed. 2d 265 (1986) (quoting Fed. R. Civ. P. 56(c)). Where the nonmoving party will have the burden of proof at trial, the movant can prevail merely by pointing out that there is an absence of evidence to support the nonmoving party’s case. *See id.*; *see also Nissan Fire & Marine Ins. Co. v. Fritz Cos.*, 210 F.3d 1099, 1106 (9th Cir. 2000) (“In order to carry its burden of production, the moving party must either produce evidence negating an essential element of the nonmoving party’s claim or defense or show that the nonmoving party does not have enough evidence of an essential element to carry its burden of persuasion at trial.”). If the moving party meets its initial burden, the nonmoving party must then set forth, by affidavit or as otherwise provided in Rule 56, “specific facts showing that there is a genuine issue for trial.” Fed. R. Civ. P. 56(e); *Anderson v. Liberty Lobby, Inc.*, 477 U.S. 242, 250, 106 S. Ct. 2505, 91 L. Ed. 2d 202 (1986).

The substantive law governing a claim determines whether a fact is material. *T.W. Elec. Serv. v. Pac. Elec. Contractors Ass’n*, 809 F.2d 626, 630 (9th Cir. 1987); *see also Long v. County of Los Angeles*, 442 F.3d 1178, 1185 (9th Cir. 2006) (“Material facts are those which may affect the outcome of the case.”) (internal citations omitted). In judging evidence at the summary judgment stage,

1 the Court does not make credibility determinations or weigh conflicting evidence  
 2 and draws all reasonable inferences in the light most favorable to the nonmoving  
 3 party. *T.W. Elec. Serv.*, 809 F.2d at 630–31; *see also Brookside Assocs. v. Rifkin*,  
 4 49 F.3d 490, 492–93 (9th Cir. 1995). The evidence presented by the parties must  
 5 be admissible. Fed. R. Civ. P. 56(e). Mere disagreement or the bald assertion  
 6 that a genuine issue of material fact exists does not preclude the use of summary  
 7 judgment. *Harper v. Wallingford*, 877 F.2d 728, 731 (9th Cir. 1989).

8 *b. CAC Allegations Regarding “Tracing”*

9 “[T]he pleading requirement [regarding traceability] is not elaborate.  
 10 Plaintiffs have not been required to explain how their shares can be traced;  
 11 general allegations that plaintiff purchased ‘pursuant to’ or traceable to false  
 12 registration statement have been held sufficient to state a claim.” *In re Global*  
 13 *Crossing, Ltd. Sec. Litig.*, 313 F. Supp. 2d 189, 208 (S.D.N.Y. 2003) (citing  
 14 *Shapiro v. UJB Financial Corp.*, 964 F.2d 272, 285–286 (3d Cir.1992); *In re*  
 15 *Crazy Eddie Sec. Litig.*, 747 F. Supp. 850, 854–55 (E.D.N.Y. 1990); *In re AES*  
 16 *Corp. Sec. Litig.*, 825 F. Supp. 578, 592 (S.D.N.Y. 1993); *Neuberger v. Shapiro*,  
 17 Fed. Sec. L. Rep. 90, 261, 1998 WL 408877, at \*2 (E.D. Pa. July 17, 1998)).  
 18 SouthWest Defendants are not able to direct the Court’s attention to any authority  
 19 where summary judgment has been granted at the pleading stage of a Section 11  
 20 action. *Cf. Persky v. Turley*, Nos. CIV 88-1830, CIV 88-2089, 1991 WL 327434,  
 21 at \*7 (D. Ariz. Dec. 19, 1991) (“Before Plaintiffs will be able to recover under  
 22 section 11, Plaintiffs will have to trace their purchases of . . . stock to one of the  
 23 allegedly misleading registration statements. At this [pre-discovery] juncture,  
 24 however, the Court cannot find that Plaintiffs can allege no facts showing that  
 25 Plaintiffs purchased their stock pursuant to one of the allegedly false registration  
 26 statements.”).

27 Here, the CAC is replete with allegations that the relevant shares are  
 28 traceable to the misleading statements. (See CAC ¶ 1 (“on behalf of all persons

1 or entities who acquired the common stock of SouthWest pursuant and/or  
2 traceable to the Company's false and misleading registration statements or  
3 prospectuses filed on Form S-3/A and S-3 on April 5, 2005 and April 19, 2006,  
4 respectively"); ¶ 26 ("Plaintiffs Nelson W. Bush, Joseph Yeatte and Thomas  
5 Moshier, as evidenced by their Certificates of Named Plaintiffs (attached hereto),  
6 purchased stock pursuant to the Company's Dividend Reinvestment and Stock  
7 Purchase Plan, . . . issued pursuant or traceable to registration statements filed  
8 and/or effective during the Class Period, and suffered damages"); ¶ 196 ("on  
9 behalf of all members of the Class who purchased or otherwise acquired  
10 SouthWest common stock issued pursuant to, or traceable to, the S-3/A and S-3  
11 registration statements"); ¶ 207 ("on behalf of all members of the Class who  
12 purchased or otherwise acquired securities pursuant to, or traceable to, the  
13 Registration Statements, as amended or superceded on or after March 16, 2006").)

14 Because this matter is still in the pleading stage, SouthWest Defendants'  
15 Motion for Partial Summary Judgment is hereby DENIED. For the same reasons,  
16 the Court will not dismiss the action pending against KPMG for lack of  
17 Standing.<sup>2</sup>

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27 <sup>2</sup>KPMG's arguments are similarly unavailing, but the Court, as discussed *supra*, will still  
28 dismiss the complaint on KPMG's Motion.

## C. The Motions to Dismiss Section 11 Claims

### 1. Legal Standard

Rule 12(b)(6) permits a defendant to seek dismissal of a complaint that “fail[s] to state a claim upon which relief can be granted.” Fed. R. Civ. P. 12(b)(6). The Court must accept as true all material factual allegations in the complaint and construe them in the light most favorable to the plaintiff. *Nursing Home Pension Fund, Local 144 v. Oracle Corp.*, 380 F.3d 1226, 1229 (9th Cir. 2004). However, this tenet is inapplicable to legal conclusions. *Ashcroft v. Iqbal*, 129 S. Ct. 1937, 1949 (2009). The Court need not accept as true “[t]hreadbare recitals of the elements of a cause of action, supported by mere conclusory statements. . .” *Id.* The Court, based on judicial experience and common-sense, must determine whether a complaint plausibly states a claim for relief. *Id.* at 1950. If the Court dismisses the complaint, it must decide whether to grant leave to amend. Denial of leave to amend is “improper unless it is clear that the complaint could not be saved by any amendment.” *Livid Holdings Ltd. v. Salomon Smith Barney, Inc.*, 416 F.3d 940, 946 (9th Cir. 2005).

### 2. Pleading Specificity

The heightened pleading requirements of the Private Securities Litigation Reform Act (“PSLRA”) do not apply to Section 11 claims, but plaintiffs are still required to allege their claims with particularity under Federal Rule of Civil Procedure 9(b) if their complaint “sounds in fraud.” *Rubke*, 551 F.3d at 1161 (citation omitted). Rule 9(b) requires that “[i]n alleging fraud or mistake, a party must state with particularity the circumstances constituting fraud or mistake.”

To ascertain whether a complaint “sounds in fraud,” the court must normally determine, after a close examination of the language and structure of the complaint, whether the complaint alleges a unified course of fraudulent conduct and relies entirely on that course of conduct as the basis of a claim. Where . . . , however, a complaint employs the exact same factual allegations to allege violations of section 11 as it uses to allege fraudulent conduct under section 10(b) of the Exchange Act, we can assume that it sounds in fraud.



1 *Rubke*, 551 F.3d at 1161 (citations omitted). Here, there can be little question that  
 2 the CAC sounds in fraud against the Southwest Defendants and against KPMG.  
 3 It is of no moment that Plaintiffs provide a disclaimer that the Section 11 claims  
 4 do not sound in fraud. (CAC ¶¶ 197, 208.) A court in the Northern District  
 5 articulated the following factors in determining whether an ostensible Section 11  
 6 claim sounds in fraud:

7 [A]lthough plaintiffs separate allegations supporting their § 11 claims  
 8 from allegations supporting their § 10(b) claim, the § 11 allegations  
 9 nevertheless reiterate the same alleged conduct and course of conduct  
 10 which underlie the § 10(b) claim. Further, as noted by defendants,  
 11 plaintiffs allege that defendants engaged in “[f]raud” and a “fraudulent  
 12 [] scheme” resulting in misstated financial statements in the registration  
 13 statement. These same misstatements are alleged as violations in  
 plaintiffs’ § 10(b) claim. Although plaintiffs separate their § 11  
 allegations from their § 10(b) claim, the added allegations primarily  
 assert additional purported misstatements in Exchange Act filings  
 which are actionable under § 10(b) but not actionable under § 11.  
 Notably, the § 10(b) allegations incorporate all the allegations made in  
 support of plaintiffs’ Securities Act claims.

14 *In re Levi Strauss & Co. Securities Litigation*, 527 F. Supp. 2d 965, 979 (N.D.  
 15 Cal. 2007). The CAC alleges knowing conduct on the part of KPMG, i.e. that  
 16 they “knew or should have known” of certain “inadequa[cies]” and “weaknesses  
 17 in internal controls” (*see* CAC ¶¶ 185–86) and “knowing[ly], recklessly or  
 18 negligently ignored” red flags (CAC ¶ 187). Plaintiffs also made clear that they  
 19 incorporated the same facts for their Section 10 and Section 11 claims against the  
 20 SouthWest defendants. (CAC ¶ 494.) Therefore, Plaintiffs’ Section 11 claims are  
 21 subject to the heightened pleading requirements of Rule 9. Fraud allegations  
 22 must be accompanied by “the who, what, when, where, and how” of the  
 23 misconduct charged. *Vess v. Ciba-Geigy Corp. USA*, 317 F.3d 1097, 1106 (9th  
 24 Cir. 2003). “Allegations of non-fraudulent conduct need satisfy only the ordinary  
 25 notice pleading standards of Rule 8(a).” *In re Daou Systems, Inc.*, 411 F.3d 1006,  
 26 1027 (9th Cir. 2005) (citations and internal quotation marks omitted). In  
 27 addition, as discussed below, because KPMG’s statements were opinions, claims  
 28 against them must also meet a heightened pleading requirement.



### 3. Allegations Against KPMG

“[M]isleading opinions, not statements of fact, . . . can give rise to a claim under section 11 only if the complaint alleges with particularity that the statements were both objectively and subjectively false or misleading.” *Rubke*, 551 F.3d at 1162. Statements made by KPMG, as an auditor, were necessarily matters of opinion. It is not clear to this Court what statements Plaintiffs take issue with, what opinions by KPMG were objectively and subjectively false and misleading, and what additional facts Plaintiffs employ to reach this conclusion. In their claim for relief, Plaintiffs state: “KPMG did not make a reasonable investigation and did not possess reasonable grounds for believing that its representations in its audit opinions and SouthWest’s financial statements for 2004, 2005, 2006 and 2007 were true, did not omit any material facts and were not materially misleading.” (CAC ¶ 215.) To find support for this allegation, one must sift through the disjointed allegations against KPMG. (*See, e.g.*, CAC ¶¶ 179–80.) For example, Plaintiffs allege that KPMG violated various professional standards such as Generally Accepted Auditing Standards. These allegations, however, are conclusory and do not allege with particularity that any opinions by KPMG were objectively and subjectively false or misleading. (*See* CAC ¶¶ 181–82 (listing standards in bullet points and baldly asserting that they are false.)) The closest Plaintiffs come to alleging objective and subjective falsity is an allegation hinting that KPMG’s 2004 pre-class assessment of SWWC’s material weaknesses somehow imparts subjective falsity onto KPMG’s opinions regarding class-period deficiencies. (*See generally* CAC ¶¶ 185–90.) This kind of allegation is too speculative to form the basis of a Section 11 cause of action.

Plaintiffs also employ the tactic of block quoting swaths of KPMG’s opinions on matters such as the adequacy of SWWC’s internal controls. The CAC then “cross-pleads” to other portions of the CAC to describe how KPMG’s opinions were false and misleading. (*See* CAC ¶ 112–13.) However, the cross-

1 referenced allegations do nothing more than refer to the restatement of SWWC's  
 2 financials, which gives no indication as to the objective or subjective nature of  
 3 KPMG's *opinions*.<sup>3</sup>

4 If Plaintiffs' allegations against KPMG are included in an amended  
 5 pleading, they must meet the heightened pleading requirements for auditors.

#### 6 **4. Allegations Against SWWC**

7 Plaintiffs allege that "[Southwest] Defendants' liability under [section 11]  
 8 is predicated on the negligence of each Defendant in making statements and  
 9 omissions in the Registration Statements, which contained untrue statements and  
 10 omissions of material fact." (CAC ¶ 197.) Plaintiffs' Section 11 allegations  
 11 related to statements made by SWWC, however, are presented in a manner that  
 12 makes it nearly impossible to discern which statements are alleged to be false.  
 13 (*See generally* CAC ¶¶ 71–195.) The CAC eschews specificity by block quoting  
 14 SEC reports, accounting treatises, and the restatement, followed by vague  
 15 references to other portions of the CAC meant to indicate falsity.

16 To provide an example, under the heading titled "Untrue Statements of  
 17 Material Fact in Registration Statements," there appear only shell delineations of  
 18 which statements are false. Part of the difficulty is that the reader must look up  
 19 cross-referenced portions of the CAC in order to discern which statements are  
 20 false and thus solve the proverbial puzzle presented by the CAC. Plaintiffs quote  
 21 statements from the 2005 10-k regarding, *inter alia*, GAAP compliance. (CAC ¶  
 22 93.) In the next paragraph, Plaintiffs follow up with meandering cross-references  
 23 to various other portions of the CAC as proof of falsity, including six CAC cross-  
 24 references. (CAC ¶ 94.)

25 Even more vexing is the CAC's tactic of inserting lengthy block quotes and  
 26 stating that the whole passage is materially false. Then, when explaining why the  
 27

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28 <sup>3</sup>This "puzzle pleading" tactic shall be addressed in greater detail *supra*.

1 passage is false, the CAC broadly asserts that “at least the following” sampling of  
 2 statements are false, without specifying exactly which purported statements show  
 3 falsity. For example, the CAC puts forth a very lengthy block quote from the  
 4 2005 10-K’s “Report of Management On Internal Control Over Financial  
 5 Reporting,” which contains general statements that internal controls were  
 6 effective. (CAC ¶ 95.) The CAC then presents the following:

7 The immediately preceding statements were materially false and  
 8 misleading when made for *at least the reasons* stated at *supra* ¶¶  
 9 162–171, 173, including that as contained in the 2008 10-K there  
 10 were at least 15 material weaknesses in internal controls over  
 11 financial reporting existing at December 31, and earlier, which  
 12 caused massive restatements to the Company’s financial statements  
 for the years ended December 31, 2004, 2005, 2006, and 2007 and  
 all interim periods included within those years and for the 2008  
 quarters ended March 31, 2008 and June 30, 2008. Thus, *at least the*  
*following statements* contained in the foregoing quoted report were  
 false and misleading when made[.]

13 (CAC ¶ 96; emphasis added.) Thus, it is not even clear which statements  
 14 Plaintiffs have elected to extract from the aforementioned block quote.

15 These problems make the task of sifting through the CAC overly  
 16 burdensome for the Court and Defendants. Ultimately, because the Court cannot  
 17 decipher valid Section 11 claims from the CAC, the Court hereby DISMISSES  
 18 these claims WITHOUT PREJUDICE.

#### 19 20 IV. SECTION 10 CLAIMS

21 In the second half of the CAC, Plaintiffs claim that the SouthWest  
 22 Defendants knowingly made material misrepresentations in their SEC filings  
 23 during the class period. The CAC, in both its Section 10 and Section 11  
 24 allegations, plainly violates Rule 8’s requirement that pleadings include “a short  
 25 and plain statement of the claim showing that the pleader is entitled to relief.”  
 26 Fed. R. Civ. Proc. 8(a)(2). The CAC, with its *more than fifty* lengthy block  
 27 quotes from which the reader must divine relevant information, does not even  
 28 come close to satisfying this standard. The CAC—even given the complex nature

1 of a securities class action—is dismissible on this ground alone, but the Court will  
 2 briefly address why the CAC’s organization also does not comply with the  
 3 PLSRA requirements.

#### 4 **A. Heightened Pleading Requirement**

5 Generally, Section 10(b) of the 1934 Act and Rule 10b-5 promulgated  
 6 thereunder “prohibit[] any person from using or employing any ‘manipulative or  
 7 deceptive device’ in connection with the sale of a security.” *In re Verifone*  
 8 *Securities Litigation*, 11 F.3d 865, 868 (9th Cir. 1993) (citing 17 C.F.R. §  
 9 240.10b-5); *see also Stoneridge Inv. Partners, LLC v. Scientific-Atlanta*, 552 U.S.  
 10 148, 157, 128 S.Ct. 761, 768 (2008) (“Rule 10b-5 encompasses only conduct  
 11 already prohibited by §10(b).”). A violation of Section 20(a) of the 1934 Act  
 12 requires: “(1) a primary violation of federal securities laws . . . and (2) that the  
 13 defendant exercised actual power or control over the primary violator.” *Howard*  
 14 *v. Everex Systems, Inc.*, 228 F.3d 1057, 1065 (9th Cir. 2000). A primary violation  
 15 consists of the “transactions giving rise to the alleged securities violation.” *Id.*  
 16 (internal citations omitted). Accordingly, if the CAC fails to articulate a Section  
 17 10(b) claim, Plaintiff’s Section 20(a) claim must also be dismissed.

18 “In a typical §10(b) private action a plaintiff must prove (1) a material  
 19 misrepresentation or omission by the defendant;<sup>[4]</sup> (2) scienter; (3) a connection  
 20 between the misrepresentation or omission and the purchase or sale of a security;  
 21 (4) reliance upon the misrepresentation or omission; (5) economic loss; and (6)  
 22 loss causation.” *Stoneridge*, 128 S. Ct. at 768. Regarding the scienter  
 23 requirement, the Ninth Circuit has also explained that the required state of mind  
 24 consists of defendants acting “with the intent to deceive or with deliberate  
 25 recklessness as to the possibility of misleading investors.” *Berson v. Applied*  
 26 *Signal Technology, Inc.*, 527 F.3d 982, 987 (9th Cir. 2008). In *Tellabs, Inc. v.*

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27  
 28 <sup>4</sup>This requirement is also referred to as the “falsity” requirement.

1 *Makor Issues & Rights, Ltd.*, 551 U.S. 308, 314, 127 S. Ct. 2499, 2504–05  
 2 (2007), the Supreme Court ruled that “[i]t does not suffice that a reasonable  
 3 factfinder plausibly could infer from the complaint’s allegations the requisite state  
 4 of mind. To qualify as ‘strong’ within the intendment of § 21D(b)(2), . . . an  
 5 inference of scienter must be more than merely plausible or reasonable—it must  
 6 be cogent and at least as compelling as any opposing inference of nonfraudulent  
 7 intent.”<sup>5</sup>

### 8 **B. Organization of the CAC/Puzzle Pleading**

9 The organizational problems set forth by the Court in the Section 11  
 10 discussion apply to the Section 10 causes of action as well. The predominant  
 11 problem with the CAC is inadequate organization and insufficient specificity to  
 12 plead adequately falsity and the requisite level of scienter. The Court will not in  
 13 this Order undertake the unnecessary burden of assessing each of the Section 10  
 14 allegations and the corresponding deficiencies. *See In re Autodesk, Inc. Securities*  
 15 *Litigation*, 132 F. Supp. 2d 833, 842 (N.D. Cal. 2000) (“The court is unwilling . . .  
 16 to search through the 51-page CAC as plaintiffs’ counsel suggested, and also finds  
 17 that it would be unfair to compel defendants to do so. As the Ninth Circuit  
 18 explained, ‘[a] complaint is not a puzzle . . . and we are loathe to allow plaintiffs  
 19 to tax defendants, against whom they have leveled very serious charges, with the  
 20 burden of solving puzzles in addition to the burden of formulating an answer to  
 21 their complaint.’”) (quoting *In re GlenFed Sec. Litig.*, 42 F.3d 1541, 1554 (9th Cir.  
 22 1994)); *Wenger v. Lumisys, Inc.*, 2 F. Supp. 2d 1231, 1244 (N.D. Cal. 1998)  
 23 (citing several “securities class action complaints, [in which] courts have  
 24 repeatedly lamented plaintiffs’ counsels’ tendency to place the burden [ ] on the

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25  
 26 <sup>5</sup>“*Tellabs* suggests that while a high level of detail is required under the PSLRA, a court  
 27 should look to the complaint as a whole, not to each individual scienter allegation[.] Thus, *Tellabs*  
 28 counsels us to consider the totality of circumstances, rather than to develop separately rules of thumb  
 for each type of scienter allegation.” *South Ferry LP, No. 2 v. Killinger*, 542 F.3d 776, 784 (9th Cir.  
 2008).

1 reader to sort out the statements and match them with the corresponding adverse  
2 facts to solve the ‘puzzle’ of interpreting Plaintiffs’ claims” and refusing to do so  
3 where the plaintiff “failed to craft a Complaint in such a way that a reader can,  
4 without undue effort, divine why each alleged statement was false or misleading”) (internal citations and quotations omitted).

5  
6 Similar to the method used in their Section 11 allegations, Plaintiffs block  
7 quote large portions of SWWC’s SEC filings, followed by blanket statements  
8 from the restatement announcement, and cross-reference other portions of the  
9 CAC. Plaintiffs lay out a separate scienter section, CAC ¶¶ 419–88, making the  
10 fatal mistake of referring to defendants in the collective rather than asserting, for  
11 each defendant, how *his or her* particular statement was false and misleading at  
12 the time it was made and any attendant strong inference of scienter. This is  
13 imperatively necessary in a case like this where the tenures of the individual  
14 defendants varied across the class period and the time during which the SEC  
15 filings were made. In all future pleadings, the Plaintiffs must respond to the  
16 heightened pleading requirement, not with four-page block quotes, *see* CAC ¶  
17 466, but with a brief, succinct description of how scienter applies to *each*  
18 defendant in this matter.

19 The Section 10 claims are hereby DISMISSED WITHOUT PREJUDICE.

### 20 **C. Claim 20(a) Claim**

21 Because the factual allegations in the CAC are not sufficient to articulate  
22 Section 10-b and Rule 10b-5 claims against Defendants, it follows that the Motion  
23 to Dismiss is also granted as to Plaintiff’s Section 20(a) claims.  
24  
25  
26  
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28

**D. Leave to Amend**

The CAC is dismissed in its entirety. Plaintiffs are hereby ordered to *strictly adhere to Rule 8(a)'s requirements* in any amended pleadings. The amended complaint must contain a succinct, terse statement of each allegation. Furthermore, Plaintiffs are instructed to adhere to the following instructions:

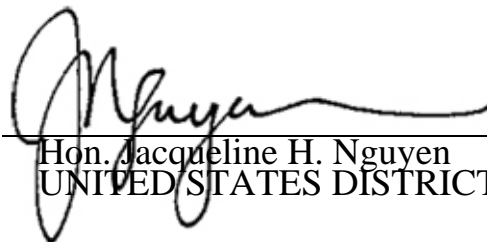
- Regarding the Section 11 allegations against KPMG, Plaintiffs must specifically set out how KPMG's *opinions* are false and misleading.
- Regarding all allegations, Plaintiffs must only reference the specific statements alleged to be false and misleading and not issue blanket, block quotes as a substitute for specific allegations.
- Excise all quotations and extraneous information not directly related to a specific count in the complaint.

**V. CONCLUSION**

Defendant SWWC's Motion for Partial Summary Judgment is DENIED. SouthWest Defendants' and KPMG's Motions to Dismiss the Consolidated Class Action Securities Complaint are GRANTED, and the Court DISMISSES WITHOUT PREJUDICE the CAC in its entirety. Plaintiffs may file an amended complaint strictly adhering to the instructions of this Order by no later than **July 30, 2010**. Failure to do so will result in this action being DISMISSED WITH PREJUDICE.

**IT IS SO ORDERED.**

Dated: June 30, 2010.



Hon. Jacqueline H. Nguyen  
UNITED STATES DISTRICT COURT